

# Lighthouse Beacon

A Guide in the 21st Century

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## Lighthouse Investment Commentary

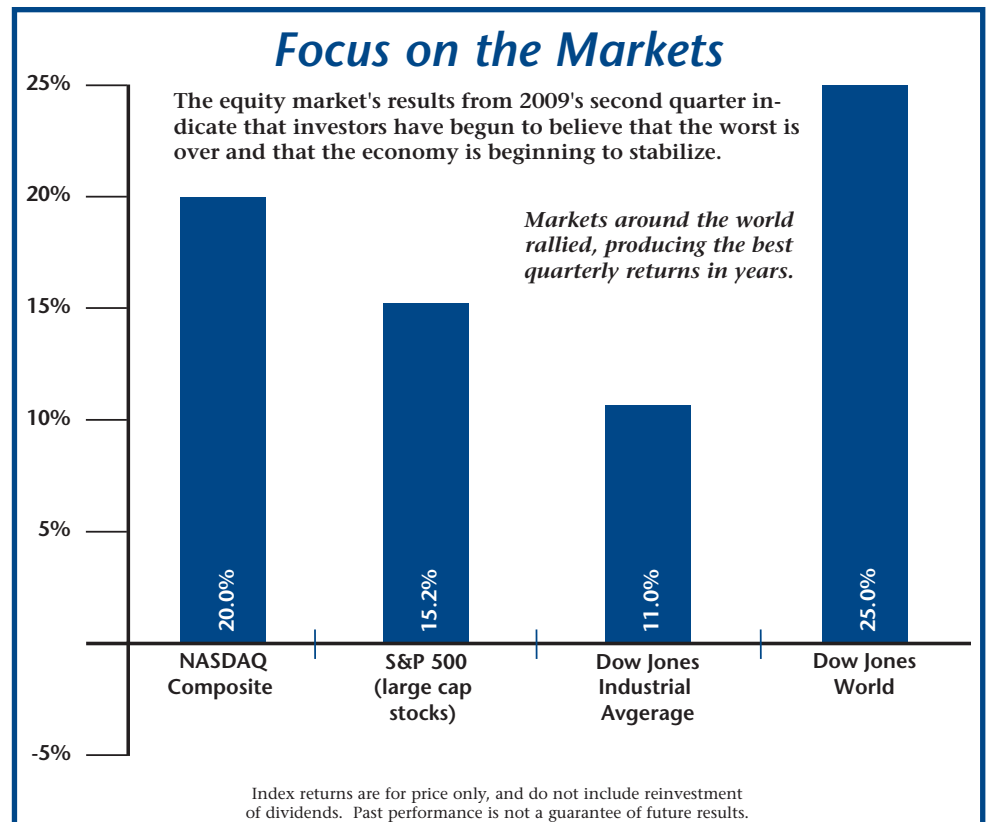
### A Recovery Should Reward Patient Investors

Don't expect business to be as it has been prior to the recession. You should expect, however, business to survive and prosper, delivering rewards to long-term investors who have the discipline to ignore the vagaries of day-to-day market psychology.

The feared economic Armageddon did not come during the second quarter of 2009, and we don't think it will come, either. Although investors' fears and anxieties persist, some of the negativism has retreated in the face of encouraging signs about the direction of the economy, and individuals and institutions have slowly started buying stocks again. The Dow Jones Industrial Average gained 838 points during the second quarter, increasing 11%. More significant, however, is the 29% rise from the 12-year low reached on March 9th. It was the first quarterly rise in the index since the third quarter of 2007.

Even after the robust market rally that began on March 9, stock prices look extraordinarily attractive to us, especially based on the expected increases in corporate earnings in 2010. Meanwhile, billions of dollars of cash remain on the sidelines, waiting to be invested and we already are seeing reports of some company earnings exceeding investor expectations.

Make no mistake: serious problems remain. Unemployment continues to rise; families still lose their homes in mortgage foreclosures; and the nation's Gross Domestic Product (GDP) remained in a sobering decline—falling by 5.5% during the first quarter of 2009. Second quarter statistics



are not yet available.

#### Evidence of Stabilization

However, we believe current stock prices already reflect the bad news, while there are new signs that the economy may have stabilized after its sharp descent. Corporate profits are showing signs of bottoming, banks are returning emergency Troubled Asset Recovery Plan (TARP) loans to the federal government, and both General Motors and Chrysler emerged from their bankruptcies in surprisingly quick fashion. Meanwhile, conditions have improved in the credit markets

as banks have begun to trust each other again and increase their lending activities, while major financial institutions have successfully increased their capital and shored up their balance sheets.

The second quarter of 2009 showed us that the worst fears would not be realized. While apprehension persists among investors, the panic that characterized the markets in late 2008 and early 2009 has passed in the face of evidence that the economy and the financial system are continuing to function. National governments and

*Continued on back*

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central banks of the United States and other nations have worked together to restore confidence and put the world economy back on the road to recovery. It has been an extraordinary period that demanded extraordinary measures.

As a result, recovery appears closer.

Little Orphan Annie was right: "The sun *will* come out tomorrow." Investors have begun to realize this and started to return to the stock market.

### **Expect Mixed Reports**

Nevertheless, after the robust rally of the second quarter, we would not be surprised to see a stock market correction of 5-10%. This should hardly be unexpected, as it would be consistent with historical trends. However, such a correction would offer a new entry point for cash sitting on the sidelines to re-enter the market.

News about the economy likely will continue to be uneven, with both encouraging reports and disappointing announcements occurring frequently. Stock prices may rise and fall in different directions daily, as investors seize on the latest economic statistic reported by the media. The market will react in one direction or the other, whether in response to a report on employment, a change in oil prices, a new trend in consumer spending or an announcement on corporate profits. Conflicting statistics will fight for attention. This is what normally occurs near the end of recession. But we are seeing stabilization, which is the first step to renewed growth. We already have witnessed signs that conditions in manufacturing, services, software and even housing are starting improve. The economy continues to lose jobs, but we should remember that unemployment historically has continued to increase even as the economy begins to recover from recession. In any event, we are beginning to see signs of a slowing in new job losses.

### **Keep Long-Term Perspective**

Somehow, though, investors need to look past each new report and the day-to-day gyrations of the market and recognize the stabilization and coming improvement in the economy. While consumer confidence remains volatile, it has improved. Investor confidence also has increased, as reflected by the amount of money that has returned to the equity markets during the past months. It is interesting that while the doom-sayers have not retreated completely, most of the conversation among economists and Wall Street analysts has turned and now revolves around the "shape of the recovery" and the timing of an economic upswing, rather than on whether an economic revival will occur.

It is impossible to predict with precision exactly when the economy will start growing again or what the trajectory of a recovery will look like. The

key here is recovery. Any recovery inevitably will lead to big profit gains, especially by companies that have reduced their costs (including payrolls) over the past year. And, don't forget, it will be increasingly easy for corporations to report earnings improvements after two years of declining profits.

What's an investor to do?

We continue to recommend keeping focused on your long-term goals, while reviewing your asset allocations and risk tolerances. Try not to be influenced by the short-term noise. Turn off CNBC.

Whether it happens in 2009 or in 2010, the economy will start growing again and disciplined investors will have new opportunities to begin recovering from the events of the past two years.

## *Lighthouse Guides*

**Q: *In light of the federal government's decision to take on record levels of new debt to stabilize the economy, are you concerned about inflation?***

**A:** The simple answer is yes. However, it is not a question that should be answered simply. Many factors will be at work influencing the direction of prices. Not all these factors lead to inevitably rising costs.

The length of the current recession has meant that a tremendous amount of unused industrial capacity has been built up. Unused or underused resources need to be put to work before greater demand starts to lead to rising inflation. The same is true of inventories.

Some corporations have allowed their inventories to decline so much that they can begin restocking supplies without adding to inflationary pressures.

The inflationary issue really is a long-term problem. The federal government's deficit will have to be brought back under control as we return to a growth environment. The next economic expansion probably will be slower and more muted than some would like. As this occurs, there will be time to deal with future revenue and spending issues. It could be a costly error to stay out of the markets based on the assumption that long-term problems will be ignored.

We don't believe fear of inflation is a reason not to invest. To be sure, inflation must be monitored and controlled, but there is time.

For information, please call or write us or visit our website at [www.lighthouseasset.com](http://www.lighthouseasset.com).

**James R. McCall**, CFA, President  
85 Eastern Avenue  
Gloucester, MA 01930  
978-282-8280  
[lighthouseasset@gmail.com](mailto:lighthouseasset@gmail.com)

**Dana P. Blake Jr.**, Executive VP  
85 Eastern Avenue  
Gloucester, MA 01930  
978-282-8285  
[ibis22000@yahoo.com](mailto:ibis22000@yahoo.com)

**Frank H. Gorke Jr.**, Senior VP  
6573 Marissa Loop  
Naples, FL 34108  
239-514-7240  
[fgorke@aol.com](mailto:fgorke@aol.com)